BVCA response to the Small Business, Enterprise and Employment Bill 2014-2015
Key Points Memorandum

This memorandum summarises the key points made by the British Private Equity and Venture Capital Association on the Small Business, Enterprise and Employment Bill 2014-2015 (the "Bill") in the attached letter. Detailed analysis of each of these points is included in the letter itself.

The PSC Register

1. In our view, the current drafting of the provisions dealing with the register of people with significant control (the "PSC Register") as they apply where shares are held indirectly through limited partnership investment funds, would not lead to an appropriate and consistent treatment of such funds, nor one which meets the policy objectives of the Bill.

2. In the UK, private equity and venture capital funds are typically structured as English Limited Partnerships ("ELPs") which do not have a separately legal personality, unlike many other (competing) partnership fund structures such as those in Cayman, Delaware and elsewhere. As a matter of partnership law, each partner in a limited partnership is deemed to have an indivisible interest in the assets of the ELP and, based on the current drafting in the Bill, if shares or rights are deemed to be held 'jointly' by partners in an ELP, this might require <u>all individuals</u> that are passive investors to be disclosed on the PSC register, irrespective of their economic interest (and in many cases, such percentages will be negligible). Depending on the size of the fund, this could lead to the disclosure of 200+ individuals which would be misleading, as none of these would have "significant control".

3. We believe the policy intent would be best achieved in this case by disclosure only of any individuals who have an interest directly or indirectly as a limited partner in the ELP (itself 'holding' >25% shares/rights etc. in a relevant company) which would equate to a "majority stake" in a limited partnership with legal personality. Drafting amendments are included in section II in the letter accompanying this memorandum.

Shadow directors

4. Whilst we support legislative clarification of the scope of duties owed by shadow directors, we do not believe that the current proposals do that in an appropriate way. In our view, as drafted, they do not provide sufficient discretion to the courts to apply the duties in a fair and proportionate manner. In particular the potential application to shadow directors of the duty of a director to avoid conflicts of interest or duties is a concern. Drafting amendments and further detail are included in section III in the letter.

Prohibition of corporate directors and the extension of this policy to LLPs

5. Our letter also includes matters which relate to the implementation of the Bill and secondary legislation, given their importance to our industry. We note that there are many reasons for using corporate directors in group structures and so the limited exceptions to their general prohibition ought to cover legitimate uses of corporate directors. We are very concerned about the potential extension of this policy to corporate members in LLPs and do not believe there is a sound justification for this extension, since members of LLPs are not equivalent to directors and do not usually have the same functions or duties. Any changes would cause very significant disruption as corporate LLP members are widely used – and needed – for a variety of legitimate reasons.

Public Bill Committee

By email: scrutiny@parliament.uk
cc. transparencyandtrust@bis.gsi.gov.uk
cc. Matthew Hancock

15 October 2014

Dear Sirs,

Re: BVCA response to the Small Business, Enterprise and Employment Bill 2014-2015

1. The British Private Equity and Venture Capital Association ("BVCA") is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. This submission has been prepared by the BVCA's Legal & Technical committee, which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry.

2. Our members have invested £33 billion in over 4,500 UK companies over the last five years. Companies backed by UK-based private equity and venture capital firms employ over half a million people and 90% of UK investments in 2012 were directed at small and medium-sized businesses. As major investors in private companies, and some public companies, our members have an interest in financial reporting matters, the conduct and information presented by such companies, and the burdens placed on the management of such companies.

I. Background

3. The BVCA is supportive of the need to promote and enhance transparency and trust in UK business. We have taken substantial steps to encourage disclosure and transparency in the private equity industry to demonstrate our commitment to transparency to our stakeholders which include investors, employees, suppliers, customers and the public more widely. In February 2007, the BVCA asked Sir David Walker to undertake an independent review of the adequacy of disclosure and transparency in private equity, with a view to recommending a set of guidelines for conformity by the industry on a voluntary basis. This review resulted in the publication of the Guidelines for Disclosure and Transparency in Private Equity (the "Walker Guidelines")[1] in November 2007. The Walker Guidelines require additional disclosure and communication by private equity firms and their larger portfolio companies when certain criteria are met.

4. While we recognise the importance of enhancing transparency and trust, we are concerned about the unintended consequences and increased burden placed on our members and their investee companies from some of these proposals. Some of the proposals featured in the discussion paper could affect the competitiveness of the UK and its attractiveness as a

[1] Further detail can be found here: http://www.walker-gmg.co.uk/

location for investment. This is at a time when the Government is promoting the UK's fund management industry (as announced in Budget 2013), recognising its role in stimulating growth and investment in SMEs.

5. This letter sets out our views on the areas covered by the Small Business, Enterprise and Employment Bill 2014-2015 (the "Bill") which are considered to be most pertinent to the private equity and venture capital industry, as well as areas we understand the Department for Business, Innovation and Skills ("BIS") is considering for further consultation and secondary legislation. Our key concerns are:

    a. The provisions dealing with the register of people with significant control (the "PSC Register") as they apply where companies registered under the Companies Act 2006 ("CA") are held indirectly through certain types of investment funds, principally limited partnerships.

    b. Proposals to increase the accountability of those who control company directors and in particular shadow directors; and

    c. The prohibition of corporate directors (with limited exceptions) and the possible extension of that prohibition to limited liability partnerships ("LLPs").

6. We have submitted a number of representations and held meetings with BIS over the course of the last year, to discuss the concerns outlined in this letter. We would like to highlight that BIS had been responsive to our concerns throughout and is considering the points we have made below.

II. The PSC Register

7. The provisions dealing with the PSC Register as they apply where CA companies are held indirectly through limited partnership style investment funds is a very important matter for the UK's private equity and venture capital industry. In our view, the current drafting in the Bill may not lead to an appropriate and consistent treatment of such funds, nor one which meets the policy objectives of the Bill. In the following sections we have outlined how private equity and venture capital funds are typically structured in the UK and how this issue arises, and suggested amendments to the Bill to deal with our concern.

Fund structures using English limited partnerships

8. Our comments here focus on the implications of investing into CA companies through an English limited partnership ("ELP") fund structure and its popularity. The limited partnership is the market standard vehicle for private equity and venture capital funds, as well as many other types of private funds in the UK, and ELPs are one of the most common type of limited partnership used, even though many foreign alternatives are now available. In our view, the popularity of the ELP is an important reason for the dominance of the UK as a centre for private equity and venture capital, and we understand this view is shared by the Government. We note, in particular, various BIS and HMT projects over many years which have aimed to improve the attractiveness of ELPs in the face of competition from vehicles established in

other countries, and the very important current project to bring forward a Legislative Reform Order in the current Parliament, as announced in the 2013 Budget.

9. Investors in private equity funds typically include institutions such as pension funds, insurance companies, family office vehicles, sovereign wealth funds and high net worth individuals. The popularity of ELPs stems from their operational flexibility and tax transparency which allows for the accommodation of specific investor requests, flexibility to determine how profits should be allocated and how the business of the ELP is to be carried out, and tax neutrality for investors that are tax-exempt (e.g. pension funds).

10. The application of the specified conditions set out in Schedule 1A (in Schedule 3 of the Bill) to shares/interests in a CA company held through an ELP is a considerably complex and fact-specific area, based on the structuring of the fund and the way it holds title to the underlying shares in the CA company.

11. Key features of ELPs are summarised below:

    a. An ELP is governed by a limited partnership agreement, common law, the Limited Partnerships Act 1907 and the Partnerships Act 1890.

    b. ELPs do not have a separate legal personality (unlike Scottish limited partnerships or those established in many other jurisdictions).

    c. An ELP must have at least one general partner ("GP") with unlimited liability and the other partners are limited partners ("LPs"). In a fund scenario, investors become LPs as they enjoy limited liability status as long as they do not participate in the management of the ELP's business. LPs are therefore passive investors in private equity and venture capital funds (akin to beneficiaries under a trust, for these purposes), and generally have no day-to-day connections with each other (as contrasted with, for example, individual partners in a trading general partnership).

    d. The GP is responsible for the day-to-day management of the business and affairs of the ELP as a matter of law, but often delegates this responsibility to a separate investment manager. That manager will typically be a separate corporate entity and, if operating in the UK, will be authorised and regulated by the Financial Conduct Authority and now (for funds which are in-scope) must be authorised and regulated by the FCA as an Alternative Investment Fund Manager. Where there is no such delegation, the GP will be authorised and regulated. The manager will not typically be a partner in the partnership.

    e. As the ELP does not have separate legal personality, practice will vary as to how legal title to the shares is registered in the books of the underlying CA company. The GP/manager may register the title to the shares in the name of the GP or manager on behalf of the ELP. Alternatively, the shares may be registered in the name of the ELP itself, or in the name of a nominee company set up by the ELP or by its manager. As a matter of partnership law, each partner in a limited partnership is deemed to have an indivisible interest in the assets of the ELP even though its economic interest and voting rights will be calculable based on the limited partnership agreement in place. However, depending upon how the ELP has chosen to hold the legal title, there may be an argument that the shares are held by the partners, including the LPs, jointly.

This would not apply if the partnership were Scottish or established in another jurisdiction which allows limited partnerships to have legal personality and in such scenarios, dependent on the holding structure, the limited partnership with legal personality is deemed to be the shareholder.

12. For illustration purposes, a simple fund structure that invests into a CA company through an ELP is included in the appendix to this letter although in practice there could be a number of variations of this.

13. In the simple example set out in the appendix, for AML purposes, the regulated GP/manager would identify any natural person who is an 'ultimate beneficial owner' in the CA company (even though from a legal perspective this may represent an indivisible interest), based on its share of profits in/commitments to the ELP. Any individual(s) who ultimately control the GP/manager would also be identified.

14. **If shares or rights are deemed to be held 'jointly' by LPs in an ELP, this might cause all individuals that are LPs to be disclosed on the PSC register, irrespective of their economic interest or voting rights.** Our view is that this does not accord with the policy intent when those individuals are passive investors in a fund structured as an ELP and have an economic interest in the CA company that is less than 25% (in many cases, such percentages will be negligible). The number of LPs varies across fund structures for a number of reasons (typically size) and it is not uncommon to have over 200 LPs in a fund. The disclosure of all individual LPs will be misleading. Those individual LPs, who do not have day-to-day connections with one another and who have delegated management to another legal entity (which, if a CA company, would typically be a relevant legal entity in relation to the CA company), cannot be said to have any meaningful influence over the underlying CA company, and to suggest so would be misleading and would obscure meaningful information.

15. We would argue that the policy intent would be best achieved in this case by disclosure only of any individuals who have an interest in the ELP (itself 'holding' >25% shares/rights etc. in a CA company) which would equate to a "majority stake" in a limited partnership with legal personality. We note that paragraph 469 of the Explanatory Notes to the Bill provides as follows:

    "The majority stake allows the person to control the legal entity in question. The person can then, by extension, control – for example - the way in which the legal entity votes its shares in company Y. Without a majority stake in the legal entity, the person will not have sufficient control to do this in respect of company Y. He or she cannot therefore be said to have significant control over company Y. In a chain of entities, this level of control needs to be reflected at each point in the chain in order that the person can be said to indirectly hold the shares or exercise rights in company Y."

16. The application of the specified conditions (as currently drafted in the Bill) creates a disincentive to use an ELP as a fund structure for investment into CA companies and would encourage the use of limited partnerships in other jurisdictions in its place (such as Scotland, Delaware and Guernsey). As mentioned above, this proposal therefore has the real potential to affect the competitiveness of the UK and its attractiveness as a location for investment at a time when the Government is seeking to promote the UK's fund management industry.

Proposed amendments to the Bill

17. To address the inconsistent treatment between funds which are structured as ELPs and those which use a partnership with legal personality (or corporate entity), we propose:

    a. The inclusion of an interpretive provision for the first (ownership of shares) condition. This provision would state that LPs in limited partnerships that do not have legal personality would not be treated as jointly "holding" shares in a CA company into which the limited partnership is invested, solely by virtue of their being LPs, and would be regarded separately for the purposes of determining their economic interest in the limited partnership (and therefore the underlying company). Given that as a matter of law LPs are not involved in management and are therefore passive investors who operate separately from each other (very much as individual shareholders in a company do) we think that this provision would be entirely consistent with the aims of the Bill. This would also more closely reflect the intended treatment in the legislation of beneficiaries under a trust, which is analogous with this scenario.

    b. Relevant amendments (reflecting our comments above) so that:

        i. any individuals who have an interest in the ELP (itself 'holding' >25% shares/rights etc. in a CA company) which would equate to a "majority stake" in a partnership with legal personality should be disclosed; and

        ii. any individuals who hold a "majority stake" in a legal entity (such as the GP) which itself holds 25.1% of the shares/rights etc. in the CA company would also be disclosed.

    c. We would also like to raise the drafting of the fifth condition which could be amended to reflect whether the Government is interested in the individuals with significant control over the company (and not the firm/trust). We note that s.790C (4)/condition 5 in Schedule 1A/paragraph 458 of the Explanatory Notes to the Bill equates LPs in an ELP with the **trustees** of a trust. From a policy perspective, we believe that it would be more appropriate to equate passive LPs in an ELP with **beneficiaries** under a trust, with the trustees being more akin to the GP.

18. We remain of the view that, in a private equity and venture capital fund context, it would be more appropriate and helpful from a transparency perspective only to disclose the identity of those individual LPs in an ELP with an interest which would equate to a "majority stake" in a limited partnership with legal personality and any individuals who hold a "majority stake" in the general partner or the investment manager to which management responsibilities have been delegated. The latter would reflect who is in control of the day-to-day activities of the ELP and ultimately the CA companies in which it has invested. We believe that our proposals would achieve that goal.

19. We are also of the view that these amendments should cover all limited partnerships without a legal personality and not just ELPs.

III. Shadow directors and proposed amendments to the Bill

20. We have closely monitored the Government's proposals to increase the accountability of those who control company directors and agree with the decision not to amend the definition of a "shadow director" in the CA. However, the current proposals allow the application of the full range of directors' duties to shadow directors, leaving some discretion to the courts as to the precise application of those duties. While we would welcome legislative clarification on this point, we think the wording used in the draft Bill in fact creates considerable additional uncertainty, whilst not providing sufficient discretion to the courts to allow them to apply the duties in a fair and proportionate manner.

21. The proposed wording, "where and to the extent capable of so applying", is very broad and effectively includes all duties since it would be hard to determine that any duty was *incapable* of applying. To afford the courts the discretion which the Government wishes to afford them as a matter of policy this wording would need to be amended, for example by using wording such as "The general duties apply to a shadow director of a company to the extent it is reasonable, just and equitable for any such general duty to apply".

22. We understand that as a matter a policy limiting the extension of these duties to the general duty to promote the success of the company was considered too narrow by the Government. One of our particular concerns (although not the only one) is the potential application to shadow directors of the duty of a director to avoid conflicts of interest or duties. It is often not possible to prevent a conflict arising and therefore the prima facie duty to avoid conflicts is typically addressed by having some mechanics allowing a director to recuse himself from any meetings considering such matters and to prevent him from voting, for example, or by the other directors approving the conflict. These mechanisms, which are specifically contemplated by the CA for *de jure* directors, will not be available to shadow directors, who in most circumstances do not seek to be shadow directors and indeed may not be subjectively aware they are shadow directors.

23. In addition, it is clear that the test of whether there is a conflict is an objective one, and there is no requirement for bad faith on the part of the director, or even knowledge that there is a relevant conflict of interest (see, for example, the recent case of *Richmond Pharmacology v Chester [2014] EWHC 2692*). Consequently the application of this duty where it is "capable" of applying may result in automatic breaches of this duty by otherwise "innocent" shadow directors. It does not appear to us to be proportionate or worthwhile to have such an onerous duty imposed automatically on all shadow directors. As such we consider that a specific carve-out for this duty would be appropriate, using the power of the Secretary of State to make such an exclusion under Section 33(3)(b). We think it would be desirable in the interests of certainty to do this in addition to adopting the suggestion above (giving the courts discretion to apply the remaining general duties when "reasonable and just and equitable") to make the position clear in relation to this particular duty.

IV. Prohibition of corporate directors and the extension of this policy to LLPs

24. This next section covers matters which relate to the implementation of the Bill and secondary legislation. We have included further detail on these areas here given their importance to our industry.

Corporate directors

25. We understand that BIS intends to consult on the limited exemptions that will be available for the general prohibition of corporate directors.

26. In many private equity structures, a series of private companies may be used as acquisition structures in order to facilitate the acquisition of the target company. These structures are necessary for a variety of reasons, including to ensure that senior debt is "structurally subordinated" to more junior debt. In our view, it is legitimate to use corporate directors in these structures, where the private company is in effect a subsidiary of another private company. We hope the proposed exemptions cover such a situation, as long as the top company in the group does not have any corporate directors. In this scenario, it should be possible to allow corporate directors of the intermediate companies, which would be administratively more convenient and should not undermine the Government's policy objective.

Corporate members in LLPs

27. We understand that BIS will also consult on whether the prohibition on corporate directors should be applied to corporate members in LLPs. We are very concerned about this and do not believe there is a sound justification for this extension, since members of LLPs are not equivalent to directors and do not usually have the same functions or duties. Any changes would cause very significant disruption as corporate LLP members are widely used – and needed – for a variety of legitimate reasons.

Differing duties

28. Members in an LLP are not equivalent to directors in a company as a matter of law as they do not owe the same statutory duties to the LLP as a director owes to a company. Members and directors are treated differently for good reason. The obligations and rights of the members of LLPs principally arise under the LLP Act. However, certain parts of the CA and of the Insolvency Act 1986 have been applied to LLPs. The CA specifically does not apply directors' duties to members but has applied certain provisions which otherwise apply to shareholders. Therefore this proposed change does not fit well with the existing legislative framework.

29. Whilst some LLP members may have a fiduciary relationship with the LLP, others may not, and this will be entirely dependent on how individual members' roles and responsibilities have been defined in the LLP's governing documents. Therefore, extending a general prohibition to corporate members in LLPs will be equivalent to preventing corporate ownership in a company as, in many cases, corporate members are simply equivalent to shareholders (as co-owners of the residual profits of the business, with certain shareholder-like rights). This is clearly not the policy intention.

30. Designated members in an LLP do have certain additional statutory duties which are more akin to a company secretary-like role rather than that of a director. As there is no proposal to require company secretaries to be natural persons, then there is no benefit in requiring a designated member to be one either (if such a proposal were to be put forward).

31. LLP members may have director-like functions if the other members give them executive management or strategic responsibilities. Where this is the case, it is highly likely that a

natural person(s) would have been allocated this role either at the level of the LLP or on the board of the corporate member. Equally, it is perfectly possible that no member of the LLP will have director-like responsibilities, but that these will have been given to non-members instead.

32. Furthermore, where there are individuals with significant control (as defined in the Bill), they will be disclosed on the PSC Register. This on its own would act as a suitable deterrent for abusive behaviour and illegal activities.

33. We note the FATF recommendations do require the Government to consider extending transparency-enhancing policy proposals to LLPs; however they also suggest the Government takes into account "their different forms and structures." A comparable statutory "director role" simply does not exist in LLPs which is why we – and many other respondents – have argued that the "consistency" justification for the extension is not supportable.

The popularity of LLPs

34. The LLP combines the internal flexibility and tax transparency of a partnership with the external disclosure and reporting regime of a company. Unlike partnerships, LLPs have the legal status of corporate bodies, and offer limited liability to members – crucially, even those who are actively involved in the management of the LLP's business. This last point underlines the popularity of LLPs in the private equity and venture capital industry (as well as the broader asset management industry). LLPs are frequently also used by the private equity industry (and others) as vehicles for consortium arrangements and joint ventures precisely because they permit members to act as "owners" and participate in profits. Excluding corporate LLP members will shut down this avenue for such structures generally, limiting the flexibility for which they were introduced.

35. Many fund managers previously structured as companies have transferred their businesses to LLP structures as they are able to operate with the added benefits of partnerships whilst retaining their limited liability status. A partnership structure allows for effective succession planning by creating incentives for key and valuable personnel (in terms of profit-sharing and partnership units' allocation) without the rigidity of a corporate share capital structure. This is desirable not only for the fund management business itself, but more importantly, investors in the funds managed. In our industry (and this would equally apply to other asset classes), retention of key personnel has become a primary investor concern with extensive time spent on due diligence of the capabilities of the management team.

36. When companies convert to LLPs, the company transfers its business and assets in exchange for an LLP interest as this ensures the transfer is not regarded as a taxable disposal. This makes perfect sense as no change in the business or its ownership has occurred and the LLP's governing agreement would reflect the economic rights previously in place. Tax would still be due in later years if the LLP were to dispose of all or part of the transferring company's previous business. This is one reason why many fund management LLPs have corporate members. Other reasons for corporate membership include the need for external seed capital or to finance expansion, and where management entities have spun out from larger corporates which retain an ownership interest (e.g. banks disposing of non-core business lines).

37. Given the prevalence of LLPs – not just in the private equity and venture capital industry but more generally – the introduction of this change would cause widespread disruption and cost to a significant number of businesses. It would in many circumstances not be permitted or contemplated by the contractual arrangements applicable to the LLPs thereby potentially triggering dispute. It would also have tax consequences. We consider that these effects are disproportionate relative to the impact such a change would have on achieving the policy objective.

Other points

38. The cost of unwinding LLP structures with LLP members would be significant with a number of consequences for many small businesses. If any proposal was put forward to ban corporate members, we would urge the Government to carry out a full cost-benefit impact analysis.

39. HMRC has reviewed partnership taxation in the last year and implemented significant changes in the Finance Bill 2014. These led to businesses in the UK (again including many small LLPs) reviewing their structures at significant cost. The changes aimed to address concerns that certain practices in LLPs led to tax avoidance and included proposals for mixed member partnerships. Therefore any concerns regarding abusive tax practices would have been addressed by HMRC.

40. The BVCA remains supportive of the need to promote and enhance transparency and trust in UK business. However, in our view, the present position, which permits corporate members of LLPs, should be maintained. In our view any changes are not only unnecessary to achieve the Government's policy objectives, but would also be hugely disruptive and costly and not appropriate given the nature of LLPs and the disparate roles of their members.

Yours faithfully

Simon Witney
Chairman – BVCA Legal and Technical Committee

Appendix – Simple English Limited Partnership fund structure